

Financial Conditions of China's State-Owned Enterprises and Implications for Reform

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Presentation Outline

- Progress on SOE reforms and core challenges
- Measuring SOE financial conditions
 - Total Factor Productivity Rank
 - Profit-Loss Categories and Groups
 - Liquidity-Solvency Indicators
- Change of SOE financial conditions
- Factors affecting SOE financial conditions
- SOEs and China's financial reform.
- Latest SOE reform initiatives of Party Plenum

Progress on SOE Reforms

- SOEs as independent legal entities
- Increase of managerial autonomy
- Contracting for profit-sharing
- Monitoring by the State and the Party
- Transformation of SOEs into corporations
- Grasping the large and letting go the small
- Severing the link b/w state and labor
- Changing the relation b/w banks and SOEs
- State as shareholder under mixed ownership

Total Factor Productivity Rank

$$\text{TFP} = \text{VA} / (\text{L}^a * \text{K}^b);$$

$$\log(\text{VA}) = a * \log(\text{L}) + b * \log(\text{K}) + \text{Log}(\text{TFP}) ;$$

- TFP: total factor productivity;
- VA: value added;
- K: net value of fixed assets;
- L: number of employees;
- **a**: **estimated** output elasticity of labor;
- **b**: **estimated** output elasticity of capital;

Profit-Loss Categories:

1. After-tax return on total assets greater than 15%.
2. After-tax return on total assets greater than 5% but less than or equal to 15%.
3. After-tax return on total assets less than or equal to 5%.
4. Cannot pay all taxes.
5. Cannot pay all taxes and depreciations.
6. Cannot pay all taxes, depreciations, and financial charges.
7. Cannot pay all taxes, depreciations, financial charges and labor costs.
8. Cannot pay all taxes, depreciations, financial charges, labor costs, and intermediate inputs.

Profit-Loss Groups:

Group EP (Excellent Profit-maker):

include profit-loss categories 1 and 2.

Group MP (Marginal Profit-maker):

include profit-loss categories 3 and 4.

Group ML (Marginal Loss-maker):

include profit-loss categories 5 and 6.

Group HL (Heavy Loss-maker):

include profit-loss categories 7 and 8.

Liquidity-Solvency Indicator

Debt-Equity Ratio:

$$\text{DER} = \frac{\text{total liabilities}}{\text{total assets} - \text{total liabilities}};$$

Liquidity-Solvency Indicator:

$$\text{LSI} = \frac{\text{net liquid assets} + \text{gross profits}}{\text{taxes} + \text{interest} + 0.2 * \text{long-term liabilities}};$$

Distribution of Profit Groups

		State-Owned Enterprises				Non-State Enterprises			
		95	96	97	98	95	96	97	98
	EP		28.4%	25.4%	24.9%		46.9%	50.9%	47.0%
	MP		48.2%	49.3%	51.3%		38.7%	30.1%	34.3%
	ML		13.9%	14.8%	13.1		10.3%	11.6%	11.8%
	HL		9.5%	10.5%	10.7		4.1%	7.4%	6.9%

Transition Matrix for Profit Groups									
Transition Probabilities		State-Owned Enterprises				Non-State Enterprises			
		1998				1998			
		EP	MP	ML	HL	EP	MP	ML	HL
1997	EP	68.9%	27.3%	2.3%	1.5%	74.3%	20.8%	3.5%	1.4%
	MP	13.0%	70.6%	10.9%	5.5%	22.0%	53.5%	19.0%	5.4%
	ML	2.5%	38.4%	40.0%	19.0%	13.1%	33.9%	42.2%	10.9%
	HL	4.0%	13.4%	20.3%	62.3%	7.3%	20.1%	20.3%	52.3%

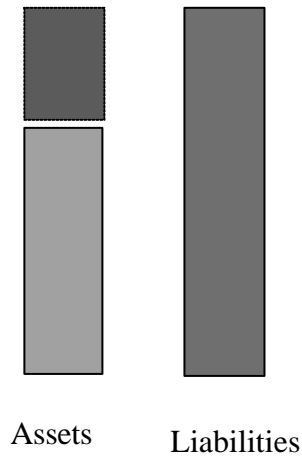
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Transition Matrix for Profit Groups									
Transition Probabilities		State-Owned Enterprises 1998				Non-State Enterprises 1998			
		EP	MP	ML	HL	EP	MP	ML	HL
1 9 9 7	EP	69%	27%	2%	2%	74%	21%	4%	1%
	MP	13%	71%	11%	6%	22%	54%	19%	5%
	ML	3%	38%	40%	19%	13%	34%	42%	11%
	HL	4%	13%	20%	62%	7%	20%	20%	52%

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The problem of state-owned enterprises and state banks

- Privatization of profits and assets.
- Socialization of losses and liabilities.
- Asset-liability imbalance in the state sector troika of enterprises, banks, and budget.



Consolidated balance sheet for China's state sector (1996 book value)

Assets in SOEs	163%	Deposits	102%
Other assets	3%	Domestic debts	6%
		Foreign debts	14%
		Implicit liabilities to SOE workers	29%
		Owner's equity	15%
Total assets	166%	Total liabilities	166%

Unit: % of GDP.

State Sector: SOEs, state banks, and state budget.

Consolidated balance sheet for China's state sector (market value if assuming bad assets amount to 25% of GDP)

Assets in SOEs	138%	Deposits	102%
Other assets	3%	Domestic debts	6%
		Foreign debts	14%
		Implicit liabilities to SOE workers	29%
		Owner's equity	-10%
Total assets	141%	Total liabilities	141%

Unit: % of GDP; Year: 1996.

State Sector: SOEs, state banks, and state budget.

Consolidated balance sheet for China's state sector (market value if assuming bad assets amount to 50% of GDP)

Assets in SOEs	113%	Deposits	102%
Other assets	3%	Domestic debts	6%
		Foreign debts	14%
		Implicit liabilities to SOE workers	29%
		Owner's equity	-35%
Total assets	116%	Total liabilities	116%

Unit: % of GDP; Year: 1996.

State Sector: SOEs, state banks, and state budget.

How to deal with negative net value of assets by the State

- Printing money → inflation.
- Borrowing now → rising national debts.
- Selling assets → not enough for liabilities.
- Financial austerity → unemployment and deflation.
- Selling national treasure → politically unacceptable.
- Increasing the net value of SOE assets → need fundamental reform of SOEs.

Unlimited liabilities SOEs and potential financial system risks

- Concentration of state control →
Concentration of state assets →
Concentration of state liabilities →
Increase of net state liabilities →
Potential for financial system risks.
- Private ownership of capital →
“surplus value”.
- Concentrated state ownership of assets →
negative net value of assets.

Why has not yet financial crisis happened in China?

- The necessary condition for financial crisis: large and increasing net liabilities for private and/or state firms and banks (e.g. bad loans).
- The sufficient condition for financial crisis: the public loses confidence in the financial system (e.g. bank-run or currency run).
- China has met the necessary condition but not yet the sufficient condition.

China has maintained public confidence in its financial system

- Central bank as effective inflation fighter.
- Central bank as credible lender of last resort.
- RMB not convertible on capital account.
- Significant trade surplus in recent years.
- Large FDI inflows since 1993.
- Large foreign exchange reserves (\$150bn).
- Low external debt (\$116bn, 14.3% of GDP).
- Low share of short-term external debt (\$14 bn).

Will China be able to avoid financial crisis in near future?

- China's backwardness implies potential for catching up.
- Low factor costs of labor, land (for non-agriculture development), and domestic capital (due to high rate of savings).
- high transaction costs (often hidden and entirely human-created barriers for doing mutually beneficial exchange and production).
- Reform of SOEs and state banks crucial for reducing transaction costs and financial system risks.

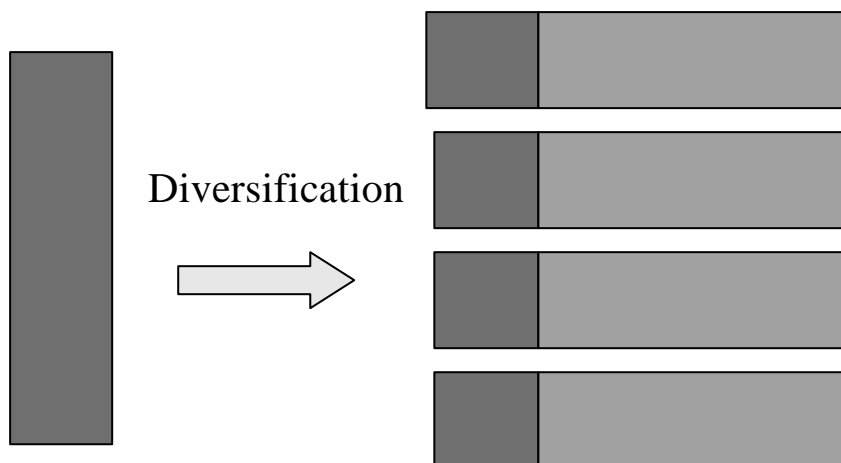
High transaction costs of restructuring ownership and control

- The judges and the legal system in China are not yet able to fine-tune and enforce property rights and contracts independently according to social justice and economic efficiency.
- The ownership and control of SOEs and banks are necessarily fragmented when the State is their sole or majority owner.
- Cost-effective financial services for buying and selling firms and banks are not yet developed.

How to reduce transaction costs in China? Learn from Hong Kong!

- The State needs to understand the tradeoff b/w state control and return to state assets.
- Best to limit the State's equity interest in any commercial businesses to less than 30%.
- Expand capital markets by listing the best firms regardless of their ownership, location, industry, etc.
- Make Hong Kong's efficient financial services available to investors and businesses in China or replicate these services in China.

The State as a passive & non-majority shareholder under mixed ownership



State as a passive & non-majority shareholder: The case of Hong Kong

- Hong Kong government's intervention in the stock market amid the Asian financial crisis made it a passive & non-majority shareholder with about 10% shares of all the listed blue-chip companies in Hong Kong.
- Hong Kong government had capital gains of significant amount as the market index almost doubled since its intervention.
- Hong Kong government did not try any interventions in the management of those blue-chip companies.

Rapid expansion of stock markets in China since 1991

- China's stock markets capitalization is only 10.9 billion yuan or 0.5% of GDP in 1991.
- But by the end of 1997, China's stock markets capitalization increased to 1753 billion yuan or 23.4% of GDP.
- China still has a long way to go in achieving a stock market capitalization of about 60%-70% of GDP as in U.S., Japan, Korea, and Taiwan.
- few privately owned firms have been listed in China's stock markets.

High risks of state bank lending

- Risks of lending to SOEs are concentrated in the state banks due to a lack of financing by equity, bond and private and foreign banks.
- To avoid corruption charges, the managers of the state banks may work hard on expanding lending to private firms.
- The moral hazard problem of excessive lending during boom and excessive tightening of credit during recession may be more serious in state banks than in private banks because of bureaucratic practices at the state banks.

How to rescue China's state banks?

The mainstream approach

- Reduce the state banks' tax burden.
- Lower capital reserve requirements.
- Re-capitalize by issuing government bonds.
- Transfer of bad assets to new asset management companies.
- Transform debt into equity at SOEs.
- Issue equity for state banks.
- Allow entry of new domestic banks.
- Allow entry of foreign banks.

Learn from Hong Kong again: Opening RMB lending business to foreign banks

- Understand the difference b/w lending and deposit-taking.
- Open RMB lending business immediately to best foreign banks.
- Keep deposit-taking monopoly for the state banks for a while during the transition.
- Let foreign banks borrow short and long-term funds from the state banks through the inter-bank markets.

China's Interbank Market Opened to 8 Foreign Banks

By KARB Y LEGGETT

Dow Jones Newswires, May 6, 1998

SHANGHAI, China -- China's decision to allow eight foreign banks to trade in its interbank and government-bond markets is a sign of its commitment to liberalize the country's financial markets. But it won't boost operations at foreign banks as long as crucial restrictions remain in place, bankers and analysts said.

China's rising foreign exchange reserves: The good news

- Reserves jumped from \$20bn in 1993 to 140bn in 1997 and 150bn in 1999 due to current account surplus, FDI, and the forced selling of all foreign exchange holdings by domestic enterprises since 1994.
- Reserves are now more than external debts and serve as a forceful backing for the stability of RMB.

China's problem with its high foreign exchange reserves

- One dollar increase in foreign exchange reserves would lead to about 8.3 yuan increase in China's domestic reserve currency.
- The size of foreign exchange reserves increased from about 15% of China's currency in circulation (M0) in 1993 to 113% of M0 (or 33% of M1 & 13% of M2) in 1997.
- Have the domestic banking system been able to handle the increased RMB currency efficiently?

Should foreign banks share one third of China's banking business?

- One third of China's money supply has been created by the inflows of foreign currency.
- China's state banks have monopolized the RMB deposits business but are not good at lending.
- The scale of foreign capital inflows as well as foreign invested enterprises and projects would justify rapid expansion of foreign banks' USD as well as RMB business in China.
- Entry of foreign business in banking and service sector would reduce transaction costs in China.

How to make RMB convertible and floating at low risks

- Fully convertible and floating RMB impossible in the near term due to time-consuming enterprise and banking reform.
- With USD or HKD as an alternative currency for legitimate international business transactions, perceived instability of RMB would have much less impact on foreign trade and investment sector in China (Compare with HK).
- China had successful experiences of using two currencies before 1994 and after 1997.

September 26, 1997

New Foreign-Exchange Rules Aim to Relieve Yuan Pressure

By KARBY LEGGETT and PETER WONACOTT

AP-Dow Jones News Service

SHANGHAI, China -- China's central bank unveiled new regulations giving exporters the right to keep their own foreign-currency earnings, in a move analysts say will relieve upward pressure on the domestic currency, the yuan.

Under the more relaxed exchange controls, which central bank Gov. Dai Xianglong revealed in an interview with the Chinese news media, exporters won't be forced to sell hard currency back to state banks. Instead, mainland companies can hold foreign exchange in their own bank accounts and convert it according to need. The rules go into effect Oct. 1, the China Securities Times reported Thursday.

CCP Decision On Reform and Development of SOEs

1. Push forward SOE reform & dev is an important and urgent task.
2. Major objectives and guiding policies of SOE reform & dev.
3. Adjust strategically the distribution of state economy.
4. Push forward the strategic reorganization of SOEs.
5. Establish and perfect the institution of modern corporation.
6. Strengthen and improve enterprise management.
7. Improve the SOE asset-liability structure and reduce the social burden of the enterprises.
8. Reducing redundant workers to improve efficiency and handle well re-employment and social safety net.
9. Speed up technical progress and industrial upgrading in SOEs.
10. Create good external environment for SOE reform & dev.
11. Establish an army of high caliber business managers.
12. Strengthen the Party's leadership on the SOE reform and dev.

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Improve asset-liability structure and reduce social burden of SOEs

1. Increase banks' bad loan reserves for merger, acquisition and bankruptcy of large and medium-sized SOEs.
2. Use debt-equity transformation to restructure highly leveraged enterprises with potential for product sales, in combination with banking reforms which transfer bad assets to financial asset management corporations.
3. Increase the weight on direct finance through stock markets. Qualified SOEs may raise capital from domestic and overseas markets. The ratio of publicly traded shares should be increased appropriately.
4. With approval, enterprises not listed in the markets may transfer with compensation the use rights on the enterprise land allocated by the State and sell enterprise assets so as to improve asset value and reduce liabilities or for structural adjustment.
5. Rigorously enforce interest policies of the State to reduce enterprise interest burden.
6. Large SOEs which are able to pay their debts may issue bonds within the State approved quote after the evaluation by qualified intermediation agencies. Some of them may issue bonds abroad.
7. Separate the social function from enterprises to reduce their social burden.

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Create good external environment for SOE reform and development

1. Maintain basic balance in economic aggregates.
2. Continue to expand economic opening.
3. Stop irrational overlapping construction.
4. Develop markets and maintain normal economic order.
5. Establish a system of intermediation services.

Related articles by Geng Xiao

“State Enterprises in China: Dealing with Loss-Makers.” Transition (World Bank), 2(11), pp. 1-3, December 1991.

“Privatization or Inflation.” Asian Wall Street Journal, 15 November 1994.

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“Learning From Deutsche Bank’s Debacle in China.” Asian Wall Street Journal, 22 May 1996.

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“Options of China’s Current Financial Reform.” In Chinese. International Economic Review (China), pp. 43-47, No.5-6, 1998.